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Review of Auckland Airport's 2022 – 2027 Price Setting Event 4 (PSE4) – Process and issues paper: Air New Zealand (Air NZ) feedback

Dear Ana

Thank you for the opportunity to respond to the Commission's proposed approach to reviewing prices set by Auckland International Airport Limited (**AIAL**).

As a substantial customer whose operation centres around Auckland Airport (**AKL**) as its global hub, Air NZ and ultimately its passengers are significantly impacted by AIAL's pricing, associated capex and operational decisions. Air NZ is the country's largest domestic and international airline, providing passenger and cargo transport services to 30 international ports. In 2023 we flew almost 16 million customers, operated 169,251 flights, and carried 114,000 tonnes of cargo to and from New Zealand.

Given its location and the lack of land-based transport infrastructure of scale, air travel and connectivity are more important to New Zealand than most other countries. Air travel reduces the economic distance within New Zealand and to the rest of the world, reducing the impact of three key economic challenges: our small scale, dispersed population, and distance from global markets. Affordable, efficient air travel connects New Zealanders to each other and to the world, promotes the travel, trade and tourism sectors and generally secures the economic wellbeing of New Zealand. Efficient investment in airport infrastructure and appropriate and affordable aeronautical charges are especially important in Auckland, the main international gateway and hub for airline operators.

This PSE4 review is a critical juncture for aviation in New Zealand. The price increases resulting from AIAL's capital programme over PSE4 and PSE5 will fundamentally alter the cost base of airlines operating to and from New Zealand's largest city, resulting in significant increases in the long-term cost of air travel for passengers and goods in New Zealand. As a result, we are deeply concerned that fewer New Zealanders and tourists will be able to afford to travel to, from and within New Zealand.

As articulated more fully in this response, the PSE4 review is also a critical juncture to assess whether the Information Disclosure (**ID**) regime for airports is serving its purpose to promote the long-term benefit of consumers within New Zealand. We do not think so. Air NZ believes the Commission should exercise its discretion under section 53B(3) of the Act to inquire into

and analyse “how effective the information disclosure requirements imposed on the goods or services are in promoting the purpose of this Part” of the Act.

Although Air NZ welcomes the scope of the draft Process and Issues paper, it is imperative that this Price Setting Event considers AIAL’s track record and where this price setting event will lead airlines, the broader aviation sector, and the NZ economy. In particular:

- Air NZ has been frustrated by AIAL’s lack of delivery. In its PSE3 submission, Air NZ welcomed AIAL’s “long overdue” \$2.4b PSE3 capex plan but cautioned that AIAL was incentivised under the ID regime to over-state and under deliver capex – and that is exactly what has happened. AIAL underspent on capex by 55% (\$668m) in the first three years of PSE3, which was during the pre-Covid period (Disclosure Years (DY) 2018 to 2020).
- Over PSE4 and PSE5, AIAL is proposing a significantly larger and even less achievable capital investment plan than in PSE3. AIAL’s PSE4 and PSE5 capital programme totals \$5.7 - \$6.7 billion (for priced assets), which will **quadruple** its regulated asset base (RAB) by 2032, while delivering very little additional capacity¹. Air NZ considers AIAL’s proposals deliver very little incremental value to customers.
- At the heart of AIAL’s capital programme for PSE4 and PSE5 is the \$3.6b Integrated Terminal Programme (ITP). Air NZ does not support the ITP in its current design and cost. Air NZ believes the ITP is too big and therefore too expensive and will result in significant cost increases for domestic and regional travellers.
- Air NZ engaged leading international engineering firm Arup to develop an alternative to the Integrated Domestic Terminal (IDT) component of the ITP which removes nearly \$1bn from the programme and retains the existing Domestic Terminal Building (DTB) in the medium-term while promoting better operational outcomes and preserving capacity to enable passenger growth. AIAL however, remains steadfast that its design is the only option.
- The retail provision in the IDT component of the ITP is closer to that of an international terminal, rather than a domestic terminal. Air NZ is therefore of the view the current design and cost of the ITP increases AIAL’s till 2 (unregulated) revenues at the expense of domestic/regional travellers.
- AIAL’s till 2 assets generate above market returns because of their proximity to the monopoly airport. Air NZ maintains that an unregulated till 2 at AIAL is not in the best long-term interests of consumers. Under a dual till, commercial profits earned by airports in the commercial till are returned to shareholders, while consumers are left to bear the cost of essential airport infrastructure. For this reason, Air NZ advocated for hybrid till regulation of airports in the context of our Civil Aviation Bill submission.
- The current ID regulatory framework provides no meaningful scope to constrain this inefficient and unaffordable capital expenditure. AIAL does not need to demonstrate the value or affordability it is delivering to its airline customers or for passengers, or that the capex it is proposing is the most efficient option. In fact, the ID regime incentivises AIAL to maximise capex during the price setting process and under deliver on capex when the regulator’s review is complete. As matters stand, AIAL is able to unilaterally determine (and

impose) charges as it sees fit in order to fund this excessive investment, subject only to its consultation obligation in the Airports Authority Act – a process that has proven to be woefully inadequate.

- In its PSE3 review, the Commission concluded that AIAL’s capex proposal was generally efficient, and that it would promote capacity growth and address several quality concerns, *with a key reason for this finding being the absence of significant concerns from major stakeholders*. The Commission noted that “Stakeholders have commented favourably on Auckland Airport’s approach to consultation and engagement, and the outcomes have generally been acceptable to participants”.ⁱⁱ
- For PSE4, the opposite is true: major airline customers and industry representatives have publicly expressed grave concerns about the capital expenditure and the resulting price shocks for consumers and regional economies. Despite the best efforts of AIAL’s substantial customers, including the engagement of world-leading airport experts at considerable expense, AIAL has consistently refused to consider alternative solutions or make material concessions to find workable solutions to mitigate these price shocks. The fundamental premise of the Commission’s conclusion on AIAL’s PSE3 capex programme no longer holds in PSE4. It is for these reasons that any earlier conclusions the Commission may have reached as to the effectiveness of the ID regime no longer hold.
- The price increases that will result from AIAL’s proposed \$5.7-\$6.7bⁱⁱⁱ capital programme over PSE4 and PSE5 are unprecedented in scale.
 - Air NZ estimates that AIAL’s priced aeronautical revenues will increase from \$339m in DY2019 (the last full regulatory year prior to Covid) to \$1.35b in DY2032^{iv} – an average annual revenue growth rate for the airport of 11.2% per annum every year for 13 years;
 - Air NZ estimates that AIAL’s average charge per domestic/regional passenger will increase from \$6.06 per passenger in DY2019 to ██████████ per passenger in DY2032^v – a total increase of over ██████████ or an average annual growth rate of ██████████ per annum every year for 13 years;
 - Consecutive price increases of this magnitude far exceed anything ever contemplated by any other regulated New Zealand infrastructure company^{vi}. For example, if AIAL were to take the approach of electricity and gas distribution businesses (with price resets at the beginning of each regulatory period, followed by CPI increases annually thereafter), the weighted average price increase in the first year of PSE4 would have been 58% followed by a subsequent 71% increase at the beginning of PSE5.
- No business in a competitive market could contemplate such significant and sustained price and revenue growth. Air NZ believes that this, coupled with AIAL’s refusal to constructively engage on an alternative design which is nearly a billion dollars cheaper, is clear evidence that the ID regime for airports is failing to promote outcomes that are consistent with outcomes produced in competitive markets and is therefore not meeting the purpose of Part 4 of the Commerce Act.

- AIAL's price increases over PSE4 and PSE5 will have significant demand impacts. This will be felt most acutely by customers using Air NZ's domestic and regional services. Air NZ's external international expert estimates AIAL's pricing for its base case capex scenario would result in a decline of over [REDACTED] in overall traffic on Air NZ's domestic network, compared to baseline growth expectations. This translates into a cumulative [REDACTED] fewer passengers travelling from Auckland to domestic and regional locations in New Zealand over the FY23-32 period. This reduction in volume is significantly higher than AIAL's forecasts and will ultimately lead, at the next pricing reset, to much higher prices than are currently being signalled by AIAL for PSE5. AIAL's high case capex scenario will lead to an even more significant suppression of demand and even higher prices from PSE5 onwards.
- AIAL's approach to pricing in PSE4 is not consistent with the purpose of Part 4 of the Commerce Act. AIAL is targeting excess revenues and profits in PSE4 via a combination of excessive and unachievable capex forecasts, an excessive and unjustified target WACC, inflated allocation of corporate costs to the regulated business and excessive and unreasonable depreciation charges. As a result of these factors, Air NZ estimates customers will pay ~\$435m more on priced services over the five-year PSE4 period than is justifiable under the Input Methodologies^{vii}. If AIAL is allowed to take the same approach to setting prices in PSE5, Air NZ estimates that customers will pay \$1.1b^{viii} more on priced services over PSE5 than justified.

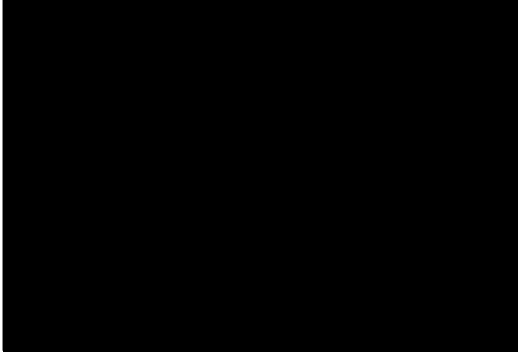
While the price increases faced by AIAL's customers in PSE4 are significant, the major impact on prices will occur in PSE5 when the full cost of the Integrated Terminal Programme (and related capex) enters the RAB. On this basis, Air NZ believes now is the time for the Commission to consider the efficiency and affordability of the entire Integrated Terminal Programme. AIAL's pattern of behaviour, enabled by the current ID regime, will see it look to its airline customers, and ultimately travelling passengers, to recoup the cost of an over-built and unaffordable capex programme, while decommissioning existing assets that could still be used to enable capacity growth.

Given the scale of the capex proposed in PSE4 and the clear interdependencies between the assets commissioned in PSE4 and PSE5 as part of the Integrated Terminal Programme, it would be an incomplete analysis to look only at the impacts of PSE4 capex. Air NZ suggests that the proposed scope of the Commission's PSE4 review should be widened to consider the combined impact of PSE4 and PSE5, given that capex commissioned but not priced in PSE4 will essentially lock-in capex that will be priced in PSE5.

The scale of AIAL's capex intentions over PSE4 and PSE5, its refusal to consider alternatives, the resounding customer objections to the extent of the capital programme, the unconscionable resultant price increases, and the scale of the excess profits targeted by AIAL showcase the impotence of the current light-handed regulatory regime.

The Commission's PSE4 review is critical – absent immediate action, consumers will pay too much for too little and AIAL customers will be committed to excessive charges with a net present value of more than \$1.5 billion over the next decade.

Regards,



Response to specific considerations**Is Auckland Airport targeting excessive profits?***General approach to assessing profitability*

1. Air NZ is of the view that AIAL is targeting excessive revenues and profits in PSE4 through a combination of excessive WACC, inefficient and excessive capital expenditure (on which it captures a margin via the inflated WACC), aggressive and potentially unreasonable depreciation, and excessive corporate allocations. Market evidence (i.e. implied RAB multiples^{ix}) suggest the market also believes that AIAL is earning a return in excess of the regulatory WACC (based on 2016 IM WACC parameters prevailing at the time of the Price Setting Event).
2. Air NZ is generally supportive of the Commission's proposed approach to assessing AIAL's ex-ante profitability over PSE4 and recommends the following:

Commission to review AIAL's forecast depreciation

3. This is covered in the response to "*Is Auckland Airport's approach to forecasting depreciation reasonable?*" from paragraph 20 below.

Commission to review AIAL's corporate allocations

4. AIAL allocates a much higher proportion of its corporate costs to the regulated business than its peers, despite having an unregulated business that is proportionally larger than its peers.^x Consumers of AIAL's regulated airport services are therefore subsidising the cost of operating AIAL's highly profitable and valuable non-regulated businesses.
5. Air NZ considers AIAL should be allocating ~50-80% of its corporate costs to its unregulated business (based on the relative contribution to operating profit of its unregulated business and the behaviour of its peers). On this basis, we estimate AIAL's excessive allocation of corporate overheads is inflating its aeronautical revenues by \$14-\$27 million annually.
6. Air NZ suggests that the Commerce Commission widens the proposed scope of its PSE4 review to include AIAL's allocation of corporate overheads to its regulated business. We recommend that the Commission should undertake its own calculation of an appropriate allocation of corporate overheads to include in its PSE4 profitability analysis.

Commission's ex-ante PSE4 profitability analysis should be based on 2016 IM WACC parameters

7. Air NZ's WACC assessment is included from paragraph 15 below.

Commission should complete the longer-term analysis of returns on AIAL's non-priced aeronautical assets recommended in its review of AIAL's PSE3 price setting. In the absence of this wider review of non-priced returns, Air NZ suggests the Commission focuses its PSE4 review solely on the returns AIAL is targeting on its priced assets.

8. AIAL is reporting a PSE4 target return for its non-priced assets that is lower than its aeronautical pricing WACC and this is reducing the overall PSE4 forecast IRR reported by AIAL. In the absence of the Commission's longer-term analysis, we suggest the Commission request of AIAL details of the proposed contract renewals on non-priced assets to assess the accuracy of its target return on non-priced assets.

Commission should investigate the significant uplift in the opening non-priced RAB for PSE4 introduced by AIAL in the final stage of its PSE4 price setting process.

9. AIAL in the final stage of its PSE4 price setting process appears to have made a significant reduction to the proportion of assets it allocates to its unregulated activities. The proportion AIAL allocates to its unregulated business reduced materially in PSE4/DY2023 to 22% (down from 30% in the prior year and relative to an average of 31% over the preceding 14 years). As a result, and subsequent to its DY2022 information disclosure, AIAL appears to have made a fundamental change to its long-held asset allocation practice which has resulted in a 17% uplift to the opening non-priced RAB for PSE4 (relative to what was disclosed in DY2022 ID) (from \$325m to \$382m).
10. AIAL has not sufficiently explained or justified this uplift in non-priced RAB, which also has the effect of diluting AIAL's reported forecast return on non-priced assets over PSE4. We suggest the Commission considers whether this change in approach is justified when it examines AIAL's target return on non-priced assets over PSE4.

Commission should incorporate the tax losses generated by AIAL over PSE3 into its ex-ante PSE4 profitability analysis

11. In its DY2022 Information Disclosure, AIAL disclosed \$72.8 million of tax losses for its regulated business. AIAL will use these tax losses to offset tax paid by its regulated business over PSE4. AIAL does not appear to have taken these tax losses into account when setting its target revenues and pricing for PSE4, and as a result AIAL is targeting excess revenue of \$20.3 million over PSE4. Air NZ believes that the Commission should incorporate these tax losses into its ex-ante PSE4 profitability analysis.

Commission should not factor AIAL's closing carry forward RAB adjustment into its PSE4 profitability analysis

12. When AIAL set prices for PSE4 in June 2023, it assumed no disposals over PSE4. Nor did AIAL disclose any PSE4 disposals in any of its PSE4 consultation documents. However subsequent to prices being set for PSE4, AIAL released (in August 2023) its PSE4 disclosures, which included PSE4 disposals of \$40.9m and an offsetting closing carry forward adjustment designed to compensate AIAL for the disposals which it had neither previously disclosed or consulted on.
13. Air NZ does not believe it is appropriate for AIAL to include this adjustment after the fact and recommends that the Commission exclude the closing adjustment from its profitability analysis.
14. If the Commission were to accept AIAL's approach with respect to adjustments after the fact, we would expect in future to see numerous subsequent adjustments for items which

AIAL had forgotten to include in its price setting consultation. This is not consistent with the concept of ex-ante regulation.

Cost of Capital

15. Air NZ considers AIAL has a history of “cherry-picking” the individual components of WACC based on an approach designed to achieve the highest WACC possible rather than selecting forecast parameters using an approach that is principled and consistent over time.
16. In PSE4 AIAL has demonstrated the above most clearly, taking draft parameters from the 2023 IM review and pre-emptively applying a selected few of these to achieve a significantly overstated target WACC of 8.73%.
17. Air NZ believes that AIAL should have set its PSE4 target return using the 2016 Input Methodologies WACC parameters and using the latest available RFR estimated by the Commission as at the start of PSE4 period (i.e. the April 2022 RFR). This approach is consistent with the general practice used by other airports. On this basis we estimate AIAL’s target WACC for PSE4 should be 6.32%. Consequently, by targeting a PSE4 WACC of 8.73%, AIAL is inflating its aeronautical revenues by ~\$230m in net present value terms over PSE4^{xi}.
18. AIAL’s target WACC for PSE4 is not supported by the 2016 IMs applicable at the time of the Price Setting Event. Air NZ recommends the Commission consider the following matters in its assessment of the appropriate WACC to apply in its ex-ante assessment of AIAL’s PSE4 profitability.

Commission to assess AIAL’s inflated asset beta.

19. AIAL has adopted an inflated asset beta based solely on updating the comparable company data to reflect recent market evidence. However, in doing so, it has ignored international regulatory precedence which considered it necessary to adjust the data covering the pandemic period to remove some of the excessive impacts evident during that time. Both the Irish Commission for Aviation Regulation and the UK CAA grappled with this issue for Dublin and London Heathrow airports respectively and concluded that adjustment was necessary. AIAL has unilaterally decided against this move, resulting in an excessive asset beta.
20. The resulting asset beta is also significantly in excess of that determined by the Commission in its 2023 Input Methodologies Review which will be used in determining the annual WACC estimates for information disclosure purposes.

Commission to assess AIAL’s use of 1 July 2022 risk-free rate (RFR)

21. For the purpose of PSE4, AIAL used an RFR inherent at the beginning of the PSE4 pricing period (the Commission’s RFR estimate of 3.6% as at 1 July 2022). AIAL claims that this “represented the latest available information at the start of the PSE4 pricing period.” Air NZ

disagrees. The 3.6% estimate was published on 2 August 2022, more than a month after the beginning of the PSE4 period, and approximately two months after the airport's pricing decision would have expected to be made based on previous precedent.

22. If AIAL had applied in PSE4 an approach consistent with usual practice by the airports, including by AIAL in PSE3 (i.e. taking the most recent estimate published by the Commission) it would have set the PSE4 WACC based upon the Commission's risk-free rate estimate published in May 2022 (2.67%), as this was the most recent estimate available if it were setting prices in June 2022. This was the approach adopted by Christchurch Airport when setting prices for the same FY2023-2027 period.
23. Air NZ suggests that a principled approach to selecting the appropriate risk-free rate component for the price setting WACC would mirror the approach the Commission uses when setting the electricity/gas DPP – i.e. the risk-free rate is estimated using data from the same time window for every pricing reset.

Is Auckland Airport's approach to forecasting depreciation reasonable?

24. AIAL has provided Air NZ with high level depreciation forecasts for PSE4 for both existing and new assets, broken down into the following categories: airfield, international terminal, integrated terminal – international, integrated terminal – domestic, DTB – new regional terminal, integrated terminal – common, other aeronautical assets. This information has not been publicly disclosed.
25. AIAL has not provided Air NZ with the depreciation rates it has used to estimate depreciation over PSE4. We also note that the Information Disclosure schedules do not enable interested parties to undertake meaningful analysis of airports' approach to regulatory depreciation. Air NZ's ability to analyse AIAL's depreciation forecasts is therefore limited to a high-level review. We recommend the Commission undertake a more detailed review as part of its PSE4 analysis, in particular the items outlined below.

Airfield

26. According to AIAL, the existing airfield assets have a remaining life of [REDACTED] years and AIAL appears to be depreciating the new airfield assets commissioned in PSE4 (\$1.18b) over an average of [REDACTED] years.
27. In the 2011 Valuation Report undertaken by Opus International Consultants^{xii}, Opus determines a life of 40-50 years for airport concrete pavements and 15-20 years for airport asphalt pavements (sections 5.6 & 5.7).
28. Based on the Opus lives for concrete and asphalt pavements and the relative volumes of concrete and asphalt expected to be laid over PSE4, Air NZ would have expected airfield assets commissioned in PSE4 to be depreciated over [REDACTED] years (as opposed to [REDACTED] years adopted by AIAL), which would reduce AIAL's airfield depreciation charges by [REDACTED] over PSE4.

29. Air NZ suggests the Commerce Commission reviews the depreciation rates that AIAL is applying to airfield capex commissioned in PSE4.

International & Integrated Terminal

30. According to AIAL, the international terminal assets have a remaining life of [REDACTED] years and AIAL appears to be depreciating the new international and the new integrated terminal assets commissioned in PSE4 (\$1.0b) over an average of [REDACTED] years.

31. Air NZ would have expected that the new terminal assets commissioned over PSE4 would have a considerably longer economic life than AIAL's existing international terminal assets, particularly those relating to the brand-new Integrated Terminal, but AIAL is proposing to fully depreciate both asset bases over a similar period.

32. In 2010 NZ Airports Association engaged Opus to prepare an analysis report on the useful or effective life of airport terminal building structure elements. The Opus Report calculated that the structural elements of the international terminal buildings at Auckland International Airport and Dunedin International Airport had a useful life between 39 and 44 years.^{xiii}

33. Air NZ therefore would have expected the PSE4 terminal expenditure would be depreciated over a much longer period than [REDACTED] years.

34. Air NZ suggests the Commerce Commission reviews the depreciation rates that AIAL is applying to international and integrated terminal capex commissioned in PSE4.

Domestic Terminal (DTB)

35. According to AIAL, the existing domestic terminal assets have a remaining life of [REDACTED] years and AIAL appears to be depreciating the new domestic terminal assets commissioned in PSE4 (\$84m) over an average of [REDACTED] years, which is significantly shorter than the economic life of these assets. AIAL's rationale for this accelerated depreciation is that the domestic terminal will be demolished during PSE5.

36. Air NZ believes that this accelerated depreciation is highly inefficient and a very poor outcome for consumers. Once the new integrated terminal is built, this relieves capacity constraints in the existing DTB enabling the use of this asset for a longer period to enable capacity growth whilst avoiding price shocks to consumers.

37. Air NZ believes it is unreasonable for AIAL to apply accelerated depreciation rates to domestic terminal expenditure commissioned during PSE4. We believe AIAL should continue to depreciate this expenditure at normal rates. If, when AIAL sets its prices for PSE5, demolition of the domestic terminal is highly likely to occur during PSE5, this can be factored into AIAL's expenditure forecasts and prices at this time.

38. Air NZ estimates that AIAL's accelerated depreciation of domestic terminal expenditure is inflating AIAL aeronautical revenues by ~ \$19m over PSE4.

39. Air NZ suggests that the Commerce Commission should not apply accelerated depreciation rates to this expenditure when it undertakes its analysis of AIAL's ex-ante profitability over PSE4.

To what extent does the demand forecast provided by Auckland Airport in its PSE4 disclosure, reasonably reflect expectations for future demand and why?

40. Air NZ is of the view that the demand forecast provided by Auckland Airport in its PSE4 disclosure materially overstates expectations for future demand, particularly after significant price increases occur once the IDT is commissioned and enters the RAB in PSE5, quadrupling the current RAB by DY2032. These increases will disproportionately impact New Zealand's domestic air traffic network.
41. Air NZ considers it a key flaw that the ID regime does not provide a mechanism for which all key parties must agree at the outset the core assumptions for an inter-generational capex programme of this scale. In this case, having not come to an agreement with the airlines on the scope for a joint demand study, AIAL proceeded to commission its own study with InterVISTAS, therefore the airlines were obliged to commission a separate study with BIS Oxford Economics (BISOE).
42. Air NZ would point out that airlines are the market experts in determining accurate price-elasticities from airline-owned fare data, how fares may be set as part of day-to-day revenue management activities, and how structural cost increases impact longer-term airline strategic decision making (e.g. fleet expansion, network growth and competitive positioning) - all of which directly feed into demand impacts at airports.
43. With the benefit of granular airline-owned fare data, and the input of Revenue Management and Networks specialists who handle the "real world revenue management practices of airlines", BISOE were able to identify and correct several anomalies inherent in the InterVISTAS report to produce a more accurate representation of demand impacts in the New Zealand market.
44. The broad points of contention between AIAL's InterVISTAS report and the Airlines' BISOE report are around the best 'scale' of elasticity to employ and around how costs are allocated to end-consumers. Air NZ considers these points have led to AIAL's underestimation of the declines in demand from the proposed airport charges.
45. Given the commercially sensitive nature of the granular data and route-level elasticities contained in the final report, Air NZ welcomes the opportunity to discuss directly with the Commission how we may make this report and our internal and external specialists available to discuss our forecast demand impacts.

Is the two-way revenue wash-up reasonable?

46. Air NZ questions whether concerns about asymmetric risk are valid in the context of a business which has the ability to set its own prices when it deems it appropriate. In the non-price-regulated world, no business can be guaranteed of achieving a full return on its investment in the event of a material asymmetric event. An event such as COVID-19 does not impact airports in isolation – all parts of the economy were severely impacted.

47. Notwithstanding the above comment, Air NZ considers the revenue wash-up is extremely favourable to AIAL. The airport has the potential to earn more than \$400M incremental to forecast revenues over the PSE4 period before the wash-up would potentially be triggered (noting there would also need to be a 0.75% uplift to IRR to trigger the mechanism). This \$400M incremental revenue is retained by the airport and does not form part of any carry forward adjustment into the next pricing period. Even at a 5% threshold, the increased revenue for the airport would be ~\$140M.
48. Air NZ requests the Commission consider whether this potential level of over-recovery is in the interest of consumers.

Is Auckland Airport investing in its assets appropriately and at a quality standard that reflects consumer demands?

49. For this question Air NZ requests that the Commission consider the following:
- AIAL's historic trend in investing both in maintaining and improving its asset base. Notably, this includes whether they have historically delivered on the capex requested by substantial customers in the timeframe they have requested and to an acceptable level of cost.
 - A review of key infrastructure issues at Auckland Airport in recent years and the core drivers of this, for example runway closures and repairs in 2018/19^{xiv} and the flooding of the terminals and runway in 2023^{xv}. In particular, Air NZ would request that the Commission consider whether historical underinvestment has contributed to these issues, necessitating capex to be undertaken on a reactive rather than a proactive basis.
 - A review of whether the price/quality or price/value equation is appropriately balanced in AIAL's proposals. This includes whether the cost of assets include elements that are designed to provide value to the airport rather than value to consumers. The construction sector in New Zealand is currently facing a number of challenges resulting in significant cost escalation and a reduced ability/willingness for either clients or contractors to lock-in prices for major projects. Traditional contracts may not provide an appropriate risk-sharing model or sufficient flexibility to effectively manage capital works projects through this environment. Given that the challenging economic conditions look set to continue, there would be benefit in the Commission reviewing the existing procurement and contract types to consider whether there are more appropriate contracts to manage, allocate and price escalation risks.

Does the level and timing of forecast capital and operational expenditure for PSE4 appear reasonable?

Capital Expenditure

50. Air NZ notes there are discrepancies in the costing information provided in the Price Setting Disclosure presentation and commentary, as well as between summary tables in the commentary and its appendices. These discrepancies range from ~\$-100m to ~\$+260m with a net difference of ~\$210m between the two documents. These discrepancies make a review of the costs in the Price Setting Disclosure challenging and reduce confidence in the transparency and accuracy of the data. A summary table is provided below.



Project	Price Setting Disclosure - Presentation	Price Setting Disclosure	Difference
1 Terminal Integration – enabling & airport resilience	1.9	1.6414	0.259
2 Terminal Integration – Domestic Processor	2.1	2.0928	0.007
3 Terminal Integration - Transport Hub	0.163	0.1635	-0.001
4 Domestic Terminal Building Upgrades	0.154	0.1483	0.006
5 Aeronautical Programme	0.631	0.7378	-0.107
6 Contingent Runway	0.14	0.1372	0.003
7 Rooding Programme	0.169	0.1639	0.005
8 Utilities Programme	0.084	0.0819	0.002
9 Renewals – airfield pavement and ground lighting	0.601	0.5841	0.017
10 Renewals - other	0.578	0.5612	0.017
11 Cargo Precinct	0.285	0.2846	0.000
	6.805	6.5967	0.208

51. As prefaced earlier in this document, it is exceptionally difficult if not impossible to consider capex in PSE4 in isolation given that the Integrated Terminal Programme spans both PSE4 and 5. This is because projects commissioned in PSE4 may have either a different cost or timing profile if they were not part of a wider Integrated Programme. An example of this is the scale of Enabling Works (\$1.5bn in PSE4) some of which may have been completed on a different timescale, and some not at all, if they were not part of an Integrated Terminal Programme.

52. Air NZ would further emphasise that given the ITP is a ‘path dependent’ programme, once it is started, the case to stop or change becomes much harder. Once AIAL sinks investment into an inefficient investment plan (under ID regulation), then the most efficient next action may be to continue these plans. If there is any concern the plan could be inefficient then now is the time to act on behalf of consumers.

53. With regards to the quantum of capex, Air NZ commissioned global engineering experts Arup to investigate whether a lower cost alternative terminal was feasible to that proposed in the \$3.6bn Integrated Terminal Programme. As part of this exercise, Arup was tasked to review the size and design of AIAL’s Integrated Domestic Terminal (IDT) against accepted global airport design benchmarks. The following conclusions were reached:

- The IDT is 25-50% oversized compared to areas generated by Arup’s Programme of Requirements (PoR) modelling and when considering the New Zealand domestic context.

- There are key operational constraints inherent in AIAL's design 
 that would lead to material operational impacts if not addressed.
- An alternative terminal design is possible that would meet Air NZ's requirements, in the same location as AIAL's IDT. This would remove nearly \$1bn from the total cost of the terminal^{xvi}, involve a simpler and right-sized pier, solve the operational constraints identified, and leverage the capacity freed up in the existing Domestic Terminal Building to reduce the need for immediate significant further capex contributing to further price shocks.

54. Air NZ is ready and willing to discuss its alternative proposals with the Commission.

55. Furthermore, Air NZ encourages the Commission to consider whether the dual till structure is influencing the size of the terminal / investment proposed, as retail provision more closely aligns with global benchmarks for international terminals than domestic terminals. In the past, AIAL has demonstrated that the profitability of the retail till is a consideration in their investment strategy. For example:

- In its 2011 annual report, AIAL discusses the implication for its retail till flowing from improvements to its terminal infrastructure: "... construction in the departures area of the international terminal building, which was completed in December 2010, has resulted in an improved passenger experience and better retail offerings which have contributed to passengers' willingness to spend. We believe we have a world-class retail experience within the international terminal."^{xvii}
- In its 2016 annual report, AIAL suggested that retail profits have to some extent motivated investment in international facilities: "The strong growth in retail revenue this financial year provides the company with confidence to construct a new international retail hub, part of the upgrade of our international departure area."^{xviii}

56. For the remaining capital expenditure, detail on the demand triggers for investment decisions is not provided in detail in the Price Setting Disclosure commentary and accordingly the need for investment from public sources needs to be inferred from the limited description of the projects provided and reference to the published Masterplan which is now 10 years old.

57. AIAL has signalled it will commit capital expenditure on physical and climate resilience expenditure over PSE4 and PSE5. This expenditure will benefit both the regulated and unregulated parts of AIAL's business. Air NZ encourages the Commission to examine AIAL's proposed allocation of this expenditure to the regulated business in PSE4 and PSE5 to ensure that AIAL's regulated business is not further subsidising its second till.

Operational Expenditure

58. AIAL's operating cost forecast for PSE4 indicates a significant increase in costs over the period, with FY27 costs almost 50% higher than FY23. Notwithstanding some need to ramp up operations as the recovery from COVID winds up, the fact that FY24 costs are forecast to be 128% of the FY19 costs, but only 90% of FY19 passenger volumes, is of major concern. Passenger volumes in FY27 are forecast to be only 7.8% higher than FY19 yet costs are forecast to be 36% higher than FY19.
59. This escalation in costs does not indicate an efficient or cost-effective approach over the course of PSE4.
60. Furthermore, we refer the Commission to our observations on Corporate Allocations made from paragraph 4.

Is the capex wash-up mechanism reasonable?

61. Air NZ supports a capex wash-up mechanism in theory, as this would ensure the risk of AIAL not delivering projects in PSE4 would not sit solely with airlines.
62. However, as with the revenue wash-up mechanism Air NZ considers the threshold AIAL proposes before this is triggered is far too high. Air New Zealand estimates that, all other things being equal, AIAL would need to underspend PSE4 capex by ~20% / \$530m before any adjustment would be required. This equates to excess revenues (return of and on capital) of ~ \$160m before any adjustment is required.
63. Air NZ believes that the adjustment mechanism, as proposed, incentivises AIAL to set capex forecasts which it would under any scenarios exceed and essentially guarantees that AIAL will earn, ex post, its target return on capital. This is not consistent with the concept of ex-ante regulation or financial capital maintenance.
64. Air NZ believes that the capex wash-up should not include the IRR test, so that the adjustment would be paid out if AIAL underspend its forecast capex. This is consistent with the IRIS approach applied under DPP regulation.
65. Air NZ would recommend the Commission model a variety of scenarios to assess whether modified thresholds may provide a better outcome for consumers.

Are there any concerns that the prices set by Auckland Airport are not efficient?

66. For this question, Air NZ considers there are two key components to consider:
- Price levels – is this the most efficient cost for what's being delivered to consumers?
 - Price structure – does the current pricing structure promote efficient pricing?

Price Levels

67. Air NZ has demonstrated that it is possible to meet Air NZ's requirements for a new domestic jet terminal, located adjacent to the international terminal, at a significantly lower cost than has been proposed by AIAL. Air NZ also believes it is inefficient to decommission existing assets (the existing domestic terminal building) which reintroduces capacity constraints which then need to be solved with further new capital expenditure (and therefore price increases).
68. Air NZ would recommend the Commission consider the following in its review:
- Are there alternative capital development plans that would more closely link RAB increases to passenger demand increases, while meeting the requirements of airlines and their passengers, thus minimising the requirement for price increases to cover the cost?
 - Has AIAL demonstrated a clear link between their capital expenditure and accepted benchmarks?
 - Has AIAL demonstrated an efficient contracting and procurement process to ensure optimal value for money during construction?
 - Has AIAL demonstrated their capex links to a clear need for capacity increases, including an analysis of whether capacity constraints may be artificially or prematurely introduced through the demolition of otherwise productive assets?
 - Has AIAL demonstrated that per passenger price increases are consistent with the benchmarks of other airports as they expand?
69. Electricity and gas distribution businesses (EDBs, GDBs) reset their revenue (prices for GDBs) at the beginning of each regulatory period, with revenues (prices for GDBs) increasing by CPI annually thereafter for the remainder of the regulatory period. If AIAL were to take this approach in PSE4 and PSE5, Air NZ estimates that the weighted average price increase in the first year of PSE4 would have been 58% followed by a subsequent 71% increase at the beginning of PSE5. Consecutive price increases of this magnitude far exceed anything ever contemplated by any other regulated New Zealand infrastructure company.
70. Air NZ notes that the cost of the IDT will be almost entirely borne by domestic jet passengers and recovered via AIAL's Domestic Passenger Charge (**DPC**). Because the cost of the IDT is so significant, the increase in this charge over PSE4 and PSE5 will be astronomical. Air NZ estimates that the DPC will increase from \$3.10 per passenger in DY2022 to ██████████ per passenger in DY2032^{xix} – a total increase of over ██████████ or an average annual growth rate of ██████████ per annum every year for 10 years – radically altering the cost and affordability of a domestic jet trip.

Price Structure

71. As mentioned above, price increases should be linked to a clear increase in value to customers and their passengers. At AIAL, pricing is broadly grouped into three categories: international; domestic jet; and regional. Air NZ is unable to see how AIAL is justifying the increase in value delivered to each type of passenger for the increases in prices proposed.
72. Therefore, Air NZ suggests that the Commission consider the following in its review:
- Has AIAL demonstrated an increase in value to be delivered to customers for the given price increases, considering this in terms of how the per-pax average costs are grouped by international; domestic jet; regional.
 - Whether certain customers are paying significantly more for either no improvement or for a worse experience. For example, compare the price increases for passengers transiting between international and domestic jet flights, to passengers transiting between domestic jet and regional flights.

Is Auckland Airport being innovative?

73. Air NZ considers that innovation and efficiency are inextricably linked, and there are three core means of demonstrating this which we recommend the Commission explore as part of its review:
- Cost efficiency (i.e. doing the same thing at a lower cost)
 - Making the existing product better (i.e. spending the same but delivering more value)
 - Product innovation (i.e. creating new sources of value for customers)
74. For AIAL, Air NZ considers it very difficult to point to clear evidence of any of these three being delivered. By contrast, the airlines have been the main source of seeking cost efficiencies, seeking greater value for customers and innovating. During PSE4, this can be demonstrated most notably in the alternative design for the integrated terminal, but also in other areas such as seeking innovative solutions to manage runway renewals in order to reduce disruption and potentially find cost savings.
75. In a workably competitive environment creating efficiencies, including through innovation, is a core element of competition. However, in the current environment where airports remain unconstrained, excessive capex is favoured over innovation. For example, if a 10% increase in passengers could be accommodated via more efficient use of the existing terminal or via increased capital expenditure, some airports maximise profit by pursuing the latter option of increased capital expenditure, rather than improving the efficiency of the existing asset. Nowhere is this more apparent than at AKL, which arguably enjoys a more entrenched monopoly position than Christchurch or Wellington, due to its location in the main population centre of NZ, and (linked to this) the Hub airport for the country's largest airline.

76. Air NZ's experience of the PSE4 consultation exercise is that AIAL appears to be resolute on solving problems predominantly through deployment of capex, rather than seeking innovative or efficient solutions collaboratively with airlines.
77. As highlighted in paragraph 58, AIAL's forecast for a significant increase in operating costs well above CPI indicates AIAL has little incentive for innovation, to demonstrate efficiency or economies of scale.

Finally, we strongly encourage the Commission to expand the scope of its review to include PSE5.

78. While the price increases faced by AIAL's customers in PSE4 are significant, the major impact on prices will occur in PSE5 when the full cost of the ITP (and related capex) enters the RAB. The \$2.6b of capex forecast to be commissioned in PSE4 will essentially lock-in a further \$3.1-\$4.1b of capex that will be commissioned and priced in PSE5. As a result, Air NZ estimates that AIAL's average charge per domestic/regional passenger will increase from \$6.06 per passenger in DY2019 to [REDACTED] per passenger in DY2032^{xx} – a total increase of over [REDACTED] or an average annual growth rate of [REDACTED] per annum every year for 13 years, significantly impacting the demand for and affordability of domestic travel.
79. As we set out in the letter at the beginning of this submission, Air NZ requests that the Commission widen the proposed scope of the PSE4 review to include the combined impact of PSE4 and PSE5. The PSE4 spend drives the PSE5 outcomes. It will be too late for the Commission to consider the PSE5 issues in five years time, because by that time the ITP will be substantially underway, reducing the size, scope and cost of the build will be impossible, and as a result customers will pay \$1.5b more on priced services over PSE4 and PSE5 than is justified.

ⁱ AIAL state in their 17 March 2023 [media release](#): “[the building programme will deliver]12 new domestic aircraft gates (20% more than at current domestic terminal).”

ⁱⁱ Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022), Draft report – Summary and analysis under section 53B(2) of the Commerce Act 1986 Date: 26 April 2018, at paragraph 141.

ⁱⁱⁱ Priced assets only

^{iv} Air NZ's estimate of AIAL's DY2032 BBAR. Key assumptions include: (i) WACC set using the AIAL's PSE4 parameters using the forecast risk free rate as at May 2027; (ii) AIAL capex forecast for PSE4 & AIAL's high capex scenario for PSE5; (iii) Air NZ's domestic volume forecasts, AIAL's international volume forecasts; and (iv) AIAL's opex forecasts for PSE4, with opex/passenger flat in real terms for PSE5.

^v We have calculated this charge by constructing separate building blocks models for AIAL's airfield, international terminal, domestic terminal and regional terminal. We calculate the BBAR for each, convert the BBAR to an NPV-equivalent smoothed revenue profile (with price resets in DY2022 and DY2028 and prices increasing at CPI annually for the remainder of each pricing period) and from there derive the underlying unit prices.

^{vi} We note that at the most recent EDB reset, 13 out of 15 companies had their revenues reset downwards by between 5 and 35%^{vi}.

vii The net present value as at 30 June 2022 of the variance between AIAL's PSE4 target revenues and Air NZ's estimate of what AIAL's PSE4 BBAR should be had it been calculated in a manner consistent with the Input Methodologies. Specific assumptions include: (i) WACC based on the prevailing 2016 Input Methodologies; (ii) reduction of ~\$20m per annum in AIAL's corporate allocations; (iii) reasonable depreciation rates for terminal and airfield capex; (iv) PSE3 tax losses of \$73m factored into BBAR; (v) Air NZ's domestic volume forecasts, AIAL's international volume forecasts

viii The net present value as at 30 June 2022 of the variance between Air NZ's estimates of: (i) what AIAL's PSE5 BBAR is likely to be (based upon its current forecasts and pricing approach taken in PSE4) and (ii) what AIAL's PSE5 BBAR should be with: (i) a WACC based on the 2023 IMs plus a forecast RFR; (ii) AIAL base case capex less \$900m as a result of ARUP's alternative terminal design; (iii) reduction of ~\$20m per annum in corporate allocations; (iv) reasonable depreciation rates for terminal and airfield capex; (v) Air NZ's domestic volume forecasts, AIAL's international volume forecasts

ix Forsyth Barr estimated in June 2023 that AIAL's regulated business trades at an implied enterprise value to RAB multiple of ~2.0x. This is consistent with average acquisition multiples in the electricity distribution sector during the period when this sector was subject to information disclosure only followed by CPI-X regulation (1998-2004). Entities subject to price quality regulation are valued at much lower multiples – for example Forsyth Barr estimated in June 2023 that Chorus and Vector trade at EV/RAB multiples of ~1.2x. Since EDBs became subject to price quality regulation in New Zealand, average acquisition multiples have reduced from ~2.0x RAB to ~1.4x RAB.

*AIAL allocates 81% of its corporate overheads to its regulated business despite its regulated business contributing only 20% of its enterprise value (based on an EV/RAB multiple of 2.0x for the regulated business). Christchurch Airport and Wellington Airport allocate significantly less corporate costs to their regulated business (53% and 58% respectively in DY2023) despite AIAL having an unregulated business that is proportionally much larger (68% unregulated EBITDA in DY2023) than either Wellington Airport (37% unregulated EBITDA in DY2023) or Christchurch Airport (59% unregulated EBITDA in DY2023).

xi This is the difference between the net present value of AIAL's target revenues over PSE4 and what AIAL's BBAR for PSE4 would have been at a target WACC of 6.3%.

xii <https://corporate.aucklandairport.co.nz/-/media/Files/Corporate/Regulatory-Disclosures/Appendix-G-Opus-Valn-of-reclaimed-landseawalls-runways-taxiways-and-aprons-2011-8107583.ashx>

xiii <https://taxworkinggroup.govt.nz/sites/default/files/2018-12/twg-subm-4032223-535c-nz-airports-association.pdf>

xiv <https://www.nzherald.co.nz/business/auckland-airport-runway-had-many-quick-stick-repairs-to-prevent-deterioration/OVDPZMJ3XJ2ES6HI7R7BFWCWSE/>

xv AIAL PSE4 Disclosure Appendix A, under the climate change resilience heading.

xvi Total cost, including aeronautical and non-aeronautical elements.

xvii AIAL, *2011 Annual Report*, p. 42 under the retail income section.

xviii AIAL, *2016 Annual Report*, p. 26.

xix We have calculated this charge by constructing a building blocks models for AIAL's domestic terminal, calculating the BBAR, converting the BBAR to an NPV-equivalent smoothed revenue profile (with price resets in DY2022 and DY2028 and prices increasing at CPI annually for the remainder of each pricing period) and from there derive the underlying DPC unit price. For key assumptions, see footnote [4]

xx We have calculated this charge by constructing separate building blocks models for AIAL's airfield, international terminal, domestic terminal and regional terminal. We calculate the BBAR for each, convert the BBAR to an NPV-equivalent smoothed revenue profile (with price resets in DY2022 and DY2028 and prices increasing at CPI annually for the remainder of each pricing period) and from there derive the underlying unit prices.